DOW THEORY LETTERS INC.

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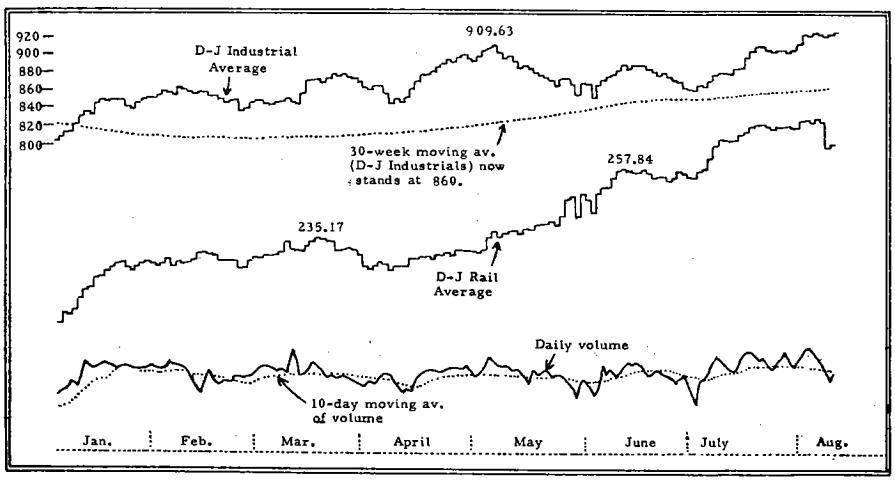
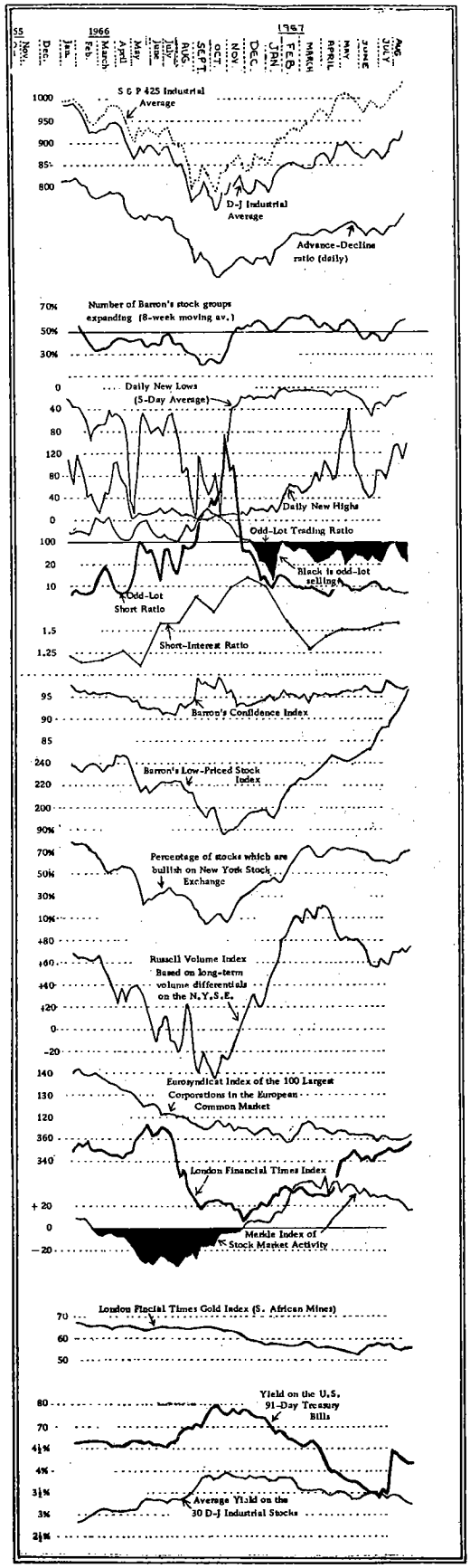
THE MARKET: The frantic speculation continues. Last week the financial fraternity made much of the fact that the Rail Average climbed to a new all-time high, a high which was confirmed by a new recovery high for the Industrial Average. Was this a primary bull signal? I do not consider it as such. The Dow Theory is concerned with much more than mechanical confirmation signals; it is concerned with yields, values, and phases. It is especially the latter to which I direct attention now.

Bear markets (like bull markets) undergo three psychological phases before they run their course. In recent Letters I have stated that the first phase of this bear market ran from the February 7, 1966 high to the October, 1966 low. I believe that we are now in the (upward) correction which separates the first from the second phase. When this advance is over, we will enter fully into the second phase of the bear market. After that we will probably have another (and much less explosive correction) and then go into the third or final phase of the bear market. This will be the phase in which quality stocks sell at great value. This will be the place where we start accumulating again.

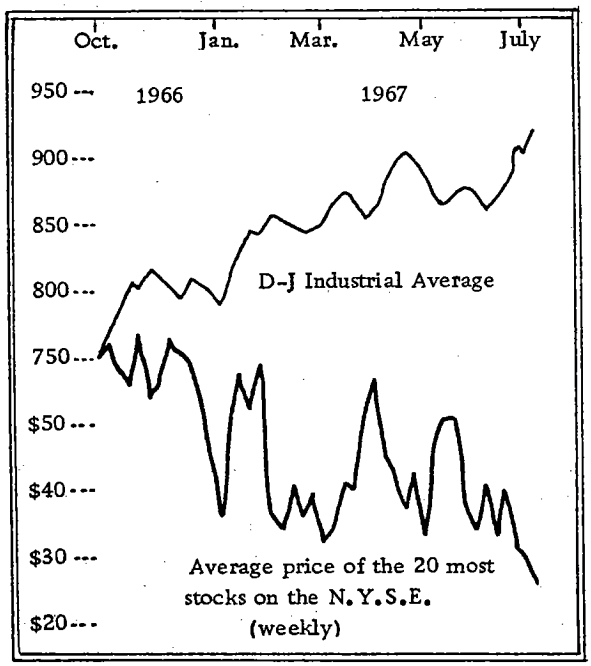
Speculation during this advance has been almost unbelievable. Last week Barron's Low-Priced Stock Index rose to another historic high of 310. Volume on the N.Y.S.E. expanded to 60.7 million, an all-time high, while Amex volume climbed to 29.9 million, almost 50% of N.Y.S.E. volume. The average price of the "20 Most Active Stocks" on the N.Y.S.E. sank to $26.38, a low for the entire rise since 1966. I have included a chart on page 2 which traces the path of the Dow and the average price of the 20 most active stocks (weekly). This chart offers dramatic testimony to the dangerous and extraordinary speculation which has engulfed this market.

When the downturn comes, it could be dramatic and all-encompassing. The decline could be directly proportional in intensity to the character of the speculation on the upside. If so, anything could occur when this market reverses itself. Chaos could reign for weeks or months. I would not want any of my subscribers to get caught in such a situation. The place for us is in liquid assets, Treasury bonds of short maturity and a 10% or 15% hedge in gold shares. Last week American South-African and Dome Mines rose to all-time highs while most other gold stocks broke out of their patterns on the upside. According to last week's Business Week, devaluation is no




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Block is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Meckle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

longer a "dirty word" in Britain, and a devaluation of the pound is now being openly advocated by leading British publications. If devaluation of the pound occurs, pressure will immediately shift to the dollar, and the entire monetary world could be thrown out of kilter. Britain's recent enforced deflation efforts have succeeded in nothing but depressing the British economy. The pressure to "reflate" is building as is the pressure to devalue. The pound is at its low of the year, but the speculation orgy in the U.S. has taken little note of all this.



Even President Johnson's recommended 10% surtax has had no effect on the crap-shooting U.S. stock markets. The urge to "make a fast buck" has swept all reason away as the crowd hurries on its frenzied rendezvous with destiny. It is really quite impossible to draw any short-term conclusions about this market. I have, in my lifetime, never seen such insistent gambling and speculation on the exchanges. All this could end in a day, a week, a month. There is no way of gauging when the speculative edifice will topple. But when it does topple, I feel it is going to "make a noise." That noise could well be loud enough to be heard around the world.

COMPARISONS: "The times are out of joint," anguished Hamlet, and he could well have been talking about 1967. On August 3, American Telephone, one of America's bluest chips, paid the highest rate for long-term financing in its entire history. On that day it marketed $250 million debentures maturing in 33 years, and the issue cost A T & T 6.06%. In 1923 "Mother Bell" put out a comparable issue at an interest cost of 5.95%. Most significantly, the common stock of Telephone now pays a dividend of $2.20, and the common stock therefore yields 4.2%. Thus the Aaa-rated bonds of Telephone offer a yield advantage of 1.8% over its own common stock. In the face of today's speculative and dangerous market conditions, in the face of all past history, this is a freakish and abnormal situation.

The Telephone bond-stock yield relationship reminded me of a comment made by Robert Rhea in the early 1930's (pertaining to the final "blow off" of 1929): "When the crash came in September-October, 1929, it was with considerable satisfaction that I realized how I had not been sucked into the whirlpool of frantic trading.....During the last three months of the excitement it was not unusual for a stock to advance more in one week than it could earn in five years. It was obvious that prices were quoted on hopes and expectation, rather than on any reasonable appraisal of the present or future value. Stocks having negative book values were advanced faster than the blue chips. Bonds which were the first mortgages on the earnings and physical assets of corporations were, in many cases, yielding far more than the common stock of those companies."

Are things any different today? In some ways yes, in others no. On September 6, 1929, the yield on the D-J 40-Bond Average was 5.18%, the yield on the Dow Industrials 3.33%. This represented a yield advantage of 1.85% in favor of bonds in 1929. On August 4, 1967, the yield on the 40-Bond Average was 5.91% while the yield on the Dow Industrials was 3.24%, for a 2.67% yield advantage in favor of bonds. Thus the yield spread is now 2.67% in favor of bonds, as against 1.85% in 1929. The situation is now fully as dangerous as the 1929 period, but today's larger yield spread is due to (1) the greater faith in Government and the more fervent belief in continuing inflation, and (2) the fact that bonds (unlike 1929) are now in the grip of a major bear market (this is discussed in a later section of this Letter).

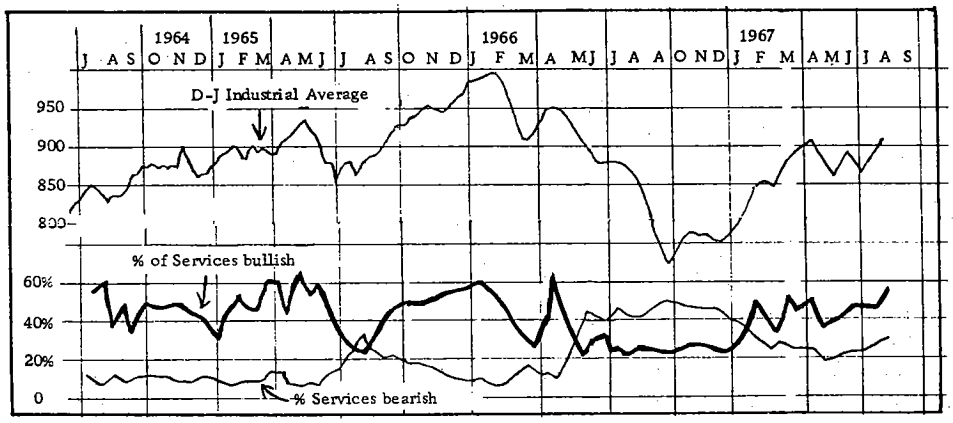
From the debt standpoint, there is a basic difference in the situation now and in 1929, and that is that during the late 1920's the nation was not at war, and, in fact, this country was actively reducing the national debt during the 1920's. Between 1921 and 1929 our national debt actually declined from $20 billion to $16 billion. Today, the debt "ceiling" is considered a financial joke; the ceiling appears more like an "up-escalator" than a top limit.

Yet, there are two important similarities between the two periods. The first is that speculation is rampant now as it was in 1929. A large public participation characterized both periods, and the stock market was resorted to as a source of "easy money" by the average citizen. Secondly, the Administration both in 1929 and today is encouraging speculative activity in the hopes of keeping the boom going. During both 1929 and 1967 the economy was acting sluggishly, and the authorities saw nothing wrong in a stock market which was caught up in frantic speculation and activity. In neither case was the possibility of a crash recognized. I feel that these comments are worth bringing to the attentions of readers.

BULLISHNESS: I have kept the accompanying chart (page 3) up to date over the past three years. It depicts statistics on the bullish or bearish position of 67 investment services. These figures are tabulated bi-monthly by Investors Intelligence of Larchmont, N.Y.

The great Dow Theorist, William P. Hamilton, stated repeatedly that he had never known the majority of professionals to be correct. This chart is in the way of a living testament to Hamilton's observation. Note that since 1964 there have been three general areas in which the "bullish percentage" of investment services climbed into the 55% to 60% area. The first time was during early 1965 when the bullish percentage rose above 60%. This was followed by the sharp sell-off of April-May, 1965.

The second area occurred during December, 1965 and again during April of 1966. This over-abundance of bullishness came just before and during the first major leg of the bear market. The most recent spate of bullishness arrived over the past few weeks. As of the last reading, the bullish percentage of investment services has climbed to 58%, the highest such percentage since April, 1966.



The suggestion would be that there are not a bit too many professional bulls riding the bandwagon. If history has any validity, this chart indicates that trouble lies ahead. The market is hysterically speculative, people have been ignoring values, the relationship between stock and bond yields is completely out of kilter, and there are now far too many professionals crowding the bull pen.

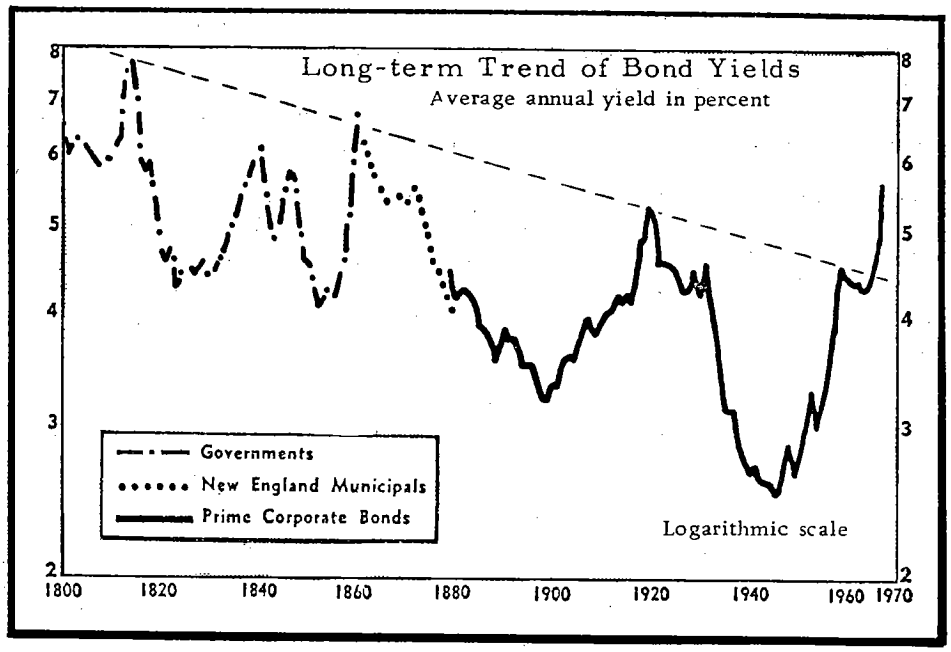
MONEY CRISIS: One can easily "miss the forest for the trees" in this business. To put it another way, one can miss the big picture because one is too close to the immediate situation. This is the reason I include very long-term charts in these Letters periodically.

Here we see a chart of interest rates in the United States from 1800 to date. Because no one form of bond offers continuity over the past 66 years, the chart necessarily traces the path of yields on three separate types of debt instruments.

I have drawn a long-term trendline through the yield peaks of the 1820's, the 1860's and the 1930's. That trendline intersects at about 4.5% today. Thus we see that the current great tidal movement in interest rates has (1) reversed the interest rate trend which has existed since 1800 and (2) pushed interest rates generally to their highest level in 100 years.

What has happened to produce this massive rise in interest rates, a rise which has seen no equal in a century? To explain this, I have turned to my friend Irving Weiss (Capital Advisors, 50 Broad St., N.Y.C.). He sees three major causes, which he refers to as "monsters," in his latest report. The three causes are (1) the massive credit inflation, (2) a great shortage of cash among U.S. financial institutions, and (3) a fantastic build-up in uncontrolled Federal expenditures.

Aside from the huge Federal deficit which is coming up and which is calculated to put further pressure on the money market, Mr. Weiss notes that our corporations are in a severe financial bind. In a tabulation of all U.S. commercial banks and corporations, Weiss found that cash reserves were $135 billion and claims on cash were $257 billion. This leaves a deficit of $122 billion. Thus the need for money during 1967 is relentless. Weiss sees a giant deficit of cash at our banks and corporations, and he is of the opinion that "it all points to much higher interest rates."

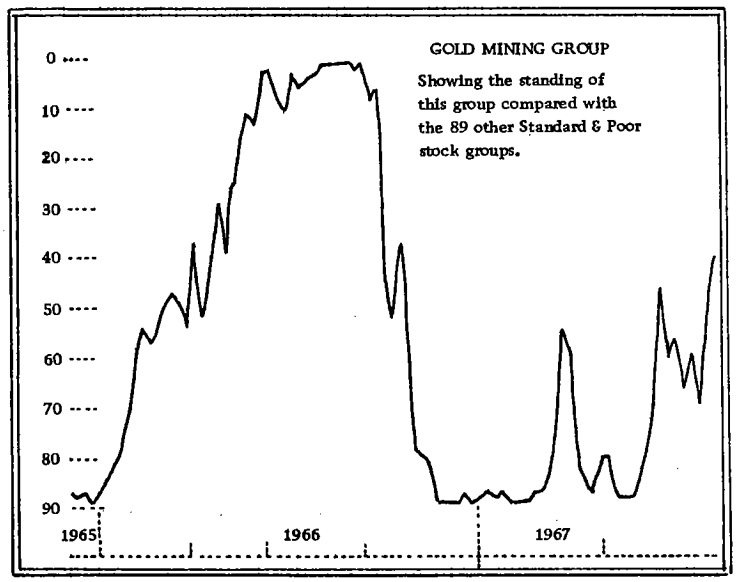


It is well to recognize the very long-term nature of the yield swings on the chart. These interest rate movements are much more extended than the major movements in the stock market. Most people, for instance, are unaware that the 1929 crash came during a long-term bull market in bonds (in which interest rates were falling). This was not without its bullish implications, and it is well to note that the peak in interest

 rates came early in the 1920's. The Great Depression therefore, occurred within the context of a major falling interest rate structure.

But currently, interest rates are still climbing, and the chart very obviously shows that any trouble which may now appear will come within the framework of a long-term bear market in bonds (with accompanying rising interest rates). I believe that any collapse in the stock market and subsequent decline in business could work towards much higher interest rates. The reason for this is that total U.S. debt must be serviced, and so far, intense business activity, high individual income and fat corporate profits have allowed the bulk of the U.S. debt to be serviced and financed without too much trouble (although currently high interest rates are an early sign of trouble). But should business decline, the current mountain of debt would constitute a severe onus on the U.S. There would be a mad scramble for liquidity (which I believe is now starting), and the search for cash would drive interest rates through the roof. This is what I look for in the period ahead. This is how the long rise in interest rates since 1946 is going to ultimately "blow its top."

GOLDS: In Letter 361 I brought this chart to the attention of readers. It shows the standing of the gold group (Standard & Poor) against the other 89 S & P groups. This study is taken from the weekly tabulations of Investors Intelligence of Larchmont, N.Y. It is based on relative strength of the gold group plotted on a 17-week cycle. The chart has, in the past, possessed excellent "lead" characteristics.



As of last week, the gold group has moved up to a high (in group standing) for 1967. Golds now rank 40, and for the second week in a row they have plus relative strength, which means that they are now acting better than the majority of other S & P groups.

I take this chart to be bullish in general for individual gold shares and bearish in general for the market. In the past, it has been characteristic of the gold group to run the gamut, from last or 89th on the group standing up to 1 or first in group standing. These movements have been counter to the main trend of the market.

The British (who are much closer to the picture than we are) are now starting to move into gold shares, and for the first time this year The Investor (a prominent British investment service) is recommending purchases of golds. "The parallels between the economic situation in 1949 and 1967 are obvious," they note in their latest report. "There's a deflationary squeeze; an improvement in export figures which has faltered through the downturn in the U.S. market; weakness of sterling in the foreign exchange markets; widespread official denials of devaluation; and a bull market in gold shares." (Note: the pound was last devalued in 1949). The Investor recommends Durban Deep and President Steyn as fresh commitments in S. African golds.

Note the path of the Gold Index on our page 1 Composite Chart. I feel that a "bullish signal" for golds would come with any rise in the Index to the 60 area. If this does occur, subscribers might wish to boost their gold position. In that event, I would suggest adding President Brand and President Steyn as new positions. Both of these may be purchased through your broker in the form of American Depository Receipts. Indicator Digest recently estimated that President Steyn's earnings could quadruple on a doubling of the price of gold. If so, the stock (if it were to sell at 10 times earnings) could appreciate 800%. This obviously constitutes a good hedge against a world-wide devaluation and say, $70 as a new price for gold.

At right (courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas) are the weekly charts of three of the most important gold equities on the N.Y.S.E. Buying is coming into these stocks. The price of silver has been "set free," and U.S. policy here has been shown to be utterly asinine. Yet in the face of official U.S. idiocy regarding silver, most people mystically believe that the Administration "knows what it is doing" when it comes to gold. The policy of pegging gold at a price of $35 per ounce for a third of a century will ultimately prove just as impossible as was the policy of pegging silver. In the meantime, the gold stocks are still in range for important buying.